> induced to remain in it by the opportunity to recoup its losses in its other markets, where the policy of uniform pricing yields revenues in excess of costs. In these circumstances, a 100% market share is a symptom of a lack, rather than the possession, of market power.[144]

That assessment is directly relevant to the unsubstantiated assertion by numerous economists that the incumbent LEC possesses market power. If an incumbent LEC has a marginal cost of $20 for its provision of basic residential service but is ordered by regulators to charge only $15, then the LEC's Lerner index for that service is −.33. The incumbent LEC has *negative* market power but virtually 100 percent of the market. Landes and Posner note that in such a case "the causality between market share and price is reversed. Instead of a large market share leading to a high price, a low price leads to a large market share; and it would be improper to infer market power simply from observing the large market share."[145] The Ninth Circuit comprehended that relationship in *Metro Mobile CTS, Inc.* v. *NewVector Communications* when it said: "Reliance on statistical market share in cases involving regulated industries is at best a tricky enterprise and is downright folly where . . . the predominant market share is the result of regulation. In such cases, the court should focus directly on the regulated firm's ability to control prices or exclude competition."[146]

D. Full Recovery of Forward-looking Costs Is Not Tantamount to "Indemnification"

151. AT&T pejoratively recasts cost recovery as "'make-whole' payments" by which "consumers [would] be forced to subsidize ILECs."[147] Similarly, some economists testifying on behalf of AT&T, such as Dr. Frederick R. Warren-Boulton, argue that "[t]he FCC's TELRIC-based pricing proposal would permit the ILEC to recover all of its forward-looking, efficient costs, including any joint and common costs, and it would be poor economic policy to indemnify any competitor against losses

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144. Landes & Posner, *supra* note 142, at 975–76.

145. *Id.* at 976.

146. 892 F.2d 62, 63 (9th Cir. 1989); *see also* Consolidated Gas Co. of Fla. v. City Gas Co., 880 F.2d 297, 300 (11th Cir.), *vacated and reh'g granted*, 889 F.2d 264 (11th Cir. 1989), *on reh'g*, 912 F.2d 1262 (11th Cir. 1990), *rev'd per curiam on other grounds*, 499 U.S. 915 (1991).

147. Comments of AT&T Corp. at 29.

associated with competition."[148] Dr. Warren-Boulton bases his argument against full cost recovery for the incumbent LEC on its supposed inefficiency: "To the extent [the incumbent LEC] is currently inefficient or its costs reflect investments in facilities which are not required to service telephone demand, these costs should not be recovered via the prices for . . . unbundled network elements."[149] Professors David Kaserman, John Mayo, and other expert witnesses for AT&T make the same argument when urging that the wholesale discount for resale of LEC services be increased by netting out monopoly rents and inefficiencies.[150]

152. That argument invites four responses. First, to date, the economists who allege this incumbent LEC inefficiency have not provided factual, let alone empirical, support for their allegation.

153. Second, it is easy to assert that a regulated firm like a local exchange carrier *must* be inherently inefficient, since regulation is inferior to competition and cannot replicate its disciplines; nonetheless, it bears emphasis that the investments of the incumbent LEC that the M-ECPR's detractors would characterize as inefficient (and thus costs that would become stranded in the face of competition) are investments that regulators approved beforehand as prudent. The argument is thus one of massive, persistent regulatory failure—for which opponents of the M-ECPR implicitly argue that the incumbent LEC should be held financially responsible.[151]

154. Third, how are inefficiencies in TELRICS to be determined? The incumbent LECs can present studies of the costs that they incur to provide service. There are considerable difficulties in devising an efficiency benchmark and then determining whether the costs incurred by LECs satisfy that efficiency standard. State regulators have traditionally not interfered with company management decisions.

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148. *Warren-Boulton Rebuttal Testimony*, *supra* note 138, at 4. "Offering a guarantee to *any* firm that it will be able to recover 'all its costs,'" Dr. Warren-Boulton continues, "is incompatible with competition and market discipline." *Id.* at 5 (emphasis in original).

149. *Warren-Boulton Testimony*, *supra* note 138, at 5-6.

150. KASERMAN REPORT, *supra* note 75, at 17-19.

151. As we have previously noted, that argument distills to the assertion that the democratic institutions that produced public utility regulation and that have been politically responsible for overseeing the performance of regulators have failed miserably. J. Gregory Sidak & Daniel F. Spulber, *Deregulatory Takings and Breach of the Regulatory Contract*, 71 N.Y.U. L. REV. 851, 991-93 (1996).

Incentive regulations, such as price caps, were introduced to provide market incentives for productive efficiency. Unsupported allegations of cost inefficiency made by a competitive entrant are subject to question. So also are arbitrary engineering cost studies that are offered as efficiency benchmarks. Furthermore, application of any such benchmark by a regulatory authority is fraught with potential problems that compound those associated with price regulation. Artificially constructed engineering studies or guesses at access costs by administrative agencies do not substantiate charges of cost inefficiency.

155. Fourth, the "indemnification" argument fails to recognize that permitting the incumbent LEC to receive the expected value of its future net revenue stream is not the same as the guaranteed receipt of the highest net revenue stream that the regulatory arrangement would have allowed. It is true that the reasonable opportunity to recover costs is not a guaranty that such cost recovery *will* occur. Rather, the opportunity is an expected value. Simply monetizing the expected flow of net revenues into a stock is not the same as a guaranteed payment of the full amount of costs incurred. Rather, it is merely the payment of the *certainty equivalent*[152] of a uncertain future stream of net revenue payments, just as a share of stock or an insurance contract has a value determined by the certainty equivalent of the various contingent outcomes envisioned by that financial instrument.

IV. The Opposing Commenters Ignore the Applicable Takings Jurisprudence or Apply It Superficially to TELRIC-based Pricing of LEC Provision of Interstate Access

156. The opposing commenters present a superficial and incomplete discussion of the takings questions posed by this proceeding. We address here four errors contained in that discussion. First, the opposing commenters ignore the entire body of takings law concerning physical invasion of private property. Second, they incorrectly apply takings case law concerning rate-regulated utilities. Third, they

152. *See, e.g.*, RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 202–04 (McGraw-Hill, Inc. 4th ed. 1991).

fail to recognize that the unbundling of the local network mandated by the Telecommunications Act of 1996 redefined the public purpose to which shareholders of the incumbent LECs had dedicated their private property, and that such a redefinition does not insulate state and federal governments from the Takings Clause for the amount to which their actions diminish the value of that private property. Fourth, the opposing parties incorrectly argue that a waiver process before the Commission will suffice to protect the rights to private property that shareholders of incumbent LECs receive from the U.S. Constitution.

A. The Opposing Commenters Choose to Ignore the Clear Relevance of *Loretto* to Cost Recovery by an Incumbent LEC That Is Required to Provide Unbundled Network Access

157. At pages 82 to 90 of our initial affidavit, we explained at length the relevance to this proceeding of the Supreme Court's leading decision on takings arising from physical invasion of property. *Loretto* v. *Teleprompter Manhattan CATV Corp.*[153] The increased pressure on the incumbent LEC to recover its full economic costs of providing interstate access services arises in substantial part from the requirements that the LEC sell UNEs, interconnection, and wholesale services at prices that will preclude the LEC from fully recovering even the *forward-looking* component of its *intrastate* costs of providing regulated service; it therefore follows *a fortiori* that the intrastate side of the LEC's business will not be able to make a positive contribution to the recovery of common network costs that have been jurisdictionally assigned to interstate access. To the contrary, the pricing of UNEs and interconnection will make it possible for arbitrage to take place in the supply of interstate access. In short, the physical occupation of the incumbent LEC's network directly affects the magnitude of common costs that the LEC will be able to recover through its sale of interstate access. Thus *Loretto* applies to the underrecovery of costs due to the pricing of interstate access, just as the decision provided the basis for a unanimous decision of the Oregon Supreme Court in 1995 that colocation constituted a physical invasion that violated the Takings Clause.[154]

153. 458 U.S. 419 (1982).

154. GTE Northwest, Inc. v. Public Util. Comm'n of Ore., 321 Ore. 458, 468–77, 900 P.2d 495, 501–06 (1995), *cert. denied*, 116 S. Ct. 1541 (1996).

B. The Opposing Commenters Fail to Comprehend the Implications of TELRIC Pricing for the Takings Analysis under *Hope* and *Duquesne*

158. AT&T attempts to defend the constitutionality of "reinitializing" price caps to TELRIC levels by arguing that the Takings Clause "requires only that a regulated entity have a fair *opportunity* to secure a reasonable return on its *overall* investment."[155] That sentence alone demands three responses. First, TELRIC pricing provides *no* opportunity for the incumbent LEC to earn a reasonable return on its investment because such pricing necessarily forces the LEC to receive total revenues that are less than total costs. Second, as explained earlier, the investment upon which the Takings Clause requires that the regulated firm receive the opportunity to earn a reasonable return is the firm's investment to provide the regulated service, *not* the firm's "overall" investment. Third, the issue presented here is one of a massive shortfall in the recovery of costs. In other words, the proposals to price interstate access at TELRIC create a virtual certainty that the incumbent LEC will be denied the opportunity not only to earn a return *on* its investment in regulated assets, but also to secure the return *of* those regulated assets by the end of their useful lives. As we explained in our initial affidavit, the severity of the problem facing the incumbent LEC is far graver than the problems facing the regulated firms in *Federal Power Commission* v. *Hope Natural Gas Co.*[156] and *Duquesne Light Co.* v. *Barasch*.[157]

159. In the next sentence, AT&T quotes the familiar language from *Hope* that a regulatory agency is "not bound to the use of any single formula" when setting rates.[158] Whatever this passage from *Hope* stands for, it surely does not mean that a regulator is free under the Takings Clause to set rates such that the total revenues from a firm's regulated activities will consistently fall below the firm's

155. Comments of AT&T Corp. at 39 (emphasis in original). MCI and WorldCom make similar arguments but discuss the relevant takings cases even more superficially than does AT&T. Comments of MCI Communications Corp. at 28-32; Comments of WorldCom, Inc. at 62-62 & n.72.

156. 320 U.S. 591 (1944).

157. 488 U.S. 299 (1989).

158. Comments of AT&T Corp. at 39 (quoting *Hope*, 320 U.S. at 602).

total costs from those activities. The standard interpretation given the quoted passage from *Hope* is that the net effect of the rate order, not its details, is what matters for constitutional purposes. "The Constitution protects the utility from the net effect of the rate order on its property. Inconsistencies in one aspect of the methodology have no constitutional effect on the utility's property if they are compensated by countervailing factors in some other aspect."[159] The requirement that a firm's total regulated revenues be allowed to cover its total regulated costs is not a particular "methodology" or "formula" of rate regulation. It is a fundamental principle of economics that reflects common sense. In more technical terms, the requirement that a firm's total regulated revenues cover its total costs is the *constraint* on the regulatory pricing problem: The regulator sets prices to maximize some measure of social welfare, subject to the constraint that the firm earns a competitive return. Correctly viewed in these terms, the break-even constraint is in no way at odds with AT&T's observation that "the Supreme Court has twice directly held that regulators are free to adopt new ratemaking principles that preclude recovery of embedded-type book costs."[160] To repeat, whether or not regulators give a regulated firm a reasonable opportunity to break even on its regulated activities is *not* a minor detail of rate setting that the Takings Clause will not disturb. Rather, it defines what must be the "net effect" of the rate regulation, which is all that *Hope* and *Duquesne* are concerned with.

160. Next, AT&T argues that "even" the incumbent LECs "do not remotely suggest that any of them would face [the] prospect" of being subjected to a rate order for interstate access with "overall rates so low as to 'jeopardize the financial integrity of the [regulated] companies, either by leaving them insufficient operating capital or by impeding their ability to raise future capital.'"[161] AT&T's sole support for that proposition consists of two quotes, one from an undated Bell Atlantic document and the

159. *Hope*, 320 U.S. at 314.

160. Comments of AT&T Corp. at 39.

161. *Id.* at 39–40 (quoting *Duquesne*, 488 U.S. at 312). MCI cites this same passage. Comments of MCI Communications Corp at 29–30.

other from a story about Pacific Bell in the trade press.[162] Yet both quotes emphasize the RBOC's potential revenues *outside* the market for regulated local telephony services, such as in-region interLATA, wireless, Internet access, and 800 services.[163] In the following paragraph, AT&T makes the shift in its argument complete by explicitly asserting that the relevant takings question is whether a "limitation on access recovery is so onerous that it will deprive ILECs of the opportunity *as firms* to earn a fair return on their *total* investment."[164] That reasoning is false. As we discussed earlier, it is no answer to the takings question to say that unregulated services may yield revenues to offset the losses which, because of a change in regulatory policy, the regulated firm will be highly likely to incur in its provision of regulated services. As we noted earlier, the Supreme Court rejected such reasoning in 1920 in *Brooks-Scanlon*.[165]

161. Finally, AT&T misstates the contractual issue at hand when it says that there "is . . . no merit to the ILECs' oft-repeated argument that changes *in ratemaking methodology* violate some legally protected 'regulatory compact.'"[166] As we explained in our initial affidavit, if it is mutually agreeable to the regulated firm and the regulator, a change in ratemaking methodology (such as a shift from rate-of-return regulation to price caps) is by itself a bilateral modification of the regulatory contract rather than a unilateral abrogation of the contract. The relevant question is therefore whether or not the change in the ratemaking methodology is voluntarily accepted by the incumbent LEC and, if it is not, whether its net effect is to deny the incumbent LEC its expectation under the regulatory contract—namely, a reasonable opportunity to recover its full economic costs of providing the regulated service.

162. AT&T further argues: "Nothing in the FCC's current access pricing rules establishes any 'vested right' or other ILEC entitlement . . . ."[167] AT&T misses the point. The question is not whether

162. Comments of AT&T Corp. at 40 n.66.
163. *Id.* Ad Hoc makes the same incorrect argument. Comments of Ad Hoc Telecommunications Users Committee at 56–60.
164. Comments of AT&T Corp. at 40 (emphasis added).
165. 251 U.S. at 399.
166. Comments of AT&T Corp. at 41 (emphasis added).
167. *Id.*

rules of the FCC's own making impose an obligation on it *vis-a-vis* the incumbent LECs. The question is whether the FCC will answer to the common law of contracts and to the Takings Clause of the U.S. Constitution. As we explained in our initial affidavit, by virtue of the agreement among the FCC and the states to allocate common costs arbitrarily across jurisdictional lines (and indeed disproportionately to the interstate account), the FCC became a party to the regulatory contract that each state had already entered into with a given incumbent LEC. The incumbent LEC's ability to recover its common costs depends upon the regulatory actions of both the FCC and the state PUCs. The Commission's decisions on the pricing of interstate access are as capable of breaching the regulatory contract as are a state PUC's decision on the pricing of UNEs and resale.

163. Citing *Duquesne* and *Market Street Railway*, AT&T then asserts that "courts have *directly* held [that] an alleged 'compact' claim adds nothing to allegations that a regulatory change effects a taking."[168] AT&T's reading of the two cases is, to put matters politely, a stretch. Nothing contained on page 303 or 313 of volume 488 of the *U.S. Reports* supports AT&T's argument. Nothing contained on page 555 or 567 of volume 324 of the *U.S. Reports* supports AT&T's argument. Neither *Duquesne* nor *Market Street Railway* can be read to repudiate the notion of the regulatory contract or to establish that a claim for breach of the regulatory contract is coextensive with, or superfluous to, a claim based on takings jurisprudence. If the Supreme Court had made such a significant pronouncement, one would expect to find the word "compact" or "contract" somewhere in *Duquesne* and *Market Street Railway*. Neither word can be found in the two decisions.

164. Even if one sets aside AT&T's curious citations, its legal argument still does not withstand scrutiny. A claim for breach of contract under the common law is a separate cause of action from a claim for just compensation under the Takings Clause of the U.S. Constitution. It may be the case, as we discussed in our initial affidavit, that the Commission could invoke a defense that would shift

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168. *Id.* (emphasis added) (citing *Duquesne*, 488 U.S. at 303, 313; Market St. Ry. v. Railroad Comm'n of Ca., 324 U.S. 548, 555, 567 (1945)).

onto the states all liability for its breach of the regulatory contract. But that is a separate matter from whether an incumbent LEC could plead a contract claim against the Commission for its adoption of a pricing policy for interstate access that had the net effect of precluding the LEC from having any reasonable opportunity to recover the common costs of the regulated services that it agreed to provide to the public.

C. The FCC Cannot Redefine the Intended Use of Private Property That an Incumbent LEC Has Dedicated to a Public Purpose Unless the Commission Simultaneously Preserves the LEC's Reasonable Opportunity to Recover Its Full Economic Costs

165. As the Commission and various commenters have noted, network unbundling under sections 251 and 252 of the Communications Act presents interexchange carriers with the opportunity to arbitrage their way around interstate access charges. What makes such arbitrage possible is that Congress has effectively redefined the public purpose to which the private property of an incumbent LEC had been dedicated. If that newly dedicated public purpose diminishes the LEC's opportunity to recover its full economic costs of providing service, a taking will have occurred.

166. The Supreme Court's 1915 decision in *Northern Pacific Railway Co.* v. *North Dakota* has great relevance to the mandatory unbundling of network access in local telephony, for the decision emphasizes that private property that a regulated utility has dedicated to a public purpose cannot be appropriated by the government for a different purpose.[169] The case involved a challenge by two railroad companies to a North Dakota statute setting maximum rates on the intrastate carriage of coal. The railroads claimed that the rates forced them to carry coal at a loss or at an uncompensatory rate (taking into account a competitive return to capital) and therefore constituted a taking of private property. Although the North Dakota Supreme Court agreed that the rates forced the companies to carry coal at a uncompensatory rate, it nonetheless deemed those rates not to be confiscatory because the companies overall continued to earn a reasonable return on their intrastate business.

169. 236 U.S. 585 (1915).

167. The Supreme Court reversed. It held that the statute was an attempt to take a carrier's property without due process of law in violation of the Fourteenth Amendment. Although the state enjoys broad power to regulate private property devoted to a public use, Justice Hughes, writing for the eight-member majority, stressed that, "the State does not enjoy the freedom of an owner."[170] That the state may reasonably regulate to ensure that a carrier fairly discharges the obligations of its charter does not mean that state may redefine the public use to which the carrier's property is dedicated, even if the carrier's total business continues to earn a sufficient return:

> The fact that the property is devoted to a public use on certain terms does not justify the requirement that it shall be devoted to other public purposes, or to the same use on other terms, or the imposition of restrictions that are not reasonably concerned with the proper conduct of the business according to the undertaking which the carrier has expressly or impliedly assumed . . . . The public interest cannot be invoked as a justification for demands which pass the limits of reasonable protection and seek to impose upon the carrier and its property burdens that are not incident to its engagement. In such a case, it would be no answer to say that the carrier obtains from its entire intrastate business a return as to the sufficiency of which in the aggregate it is not entitled to complain.[171]

As an example, Justice Hughes stated that if the firm "has held itself out as a carrier of passengers only, it cannot be compelled to carry freight."[172] This simple example from 1915 has a contemporary counterpart in the debates over mandatory unbundling of access to local telephony networks: If the regulated firm has held itself out as an integrated network providing service directly to customers, can it be compelled to rededicate that network to providing service to other (unregulated) firms that compete with the regulated firm for sales to retail customers? *Northern Pacific Railway* says no.

168. Professors Baumol and Willig have recently made the same argument with respect to railroads. Regulation of the railroads began in 1887 with the Interstate Commerce Act that established the Interstate Commerce Commission (ICC). The Railroad Revitalization and Regulatory Reform Act of 1976[173] was an initial attempt at railroad deregulation that left many regulatory controls in place.

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170. *Id.* at 595. The lone dissenter, Justice Pitney, wrote no opinion.
171. *Id.* at 595-96.
172. *Id.*
173. Pub. L. No. 94-210, 90 Stat. 31 (codified at 49 U.S.C. § 10701).

Congress substantially deregulated railroads with the Staggers Rail Act of 1980[174] and, with the ICC Termination Act of 1995,[175] replaced the ICC with the Surface Transportation Board within the Transportation Department, which continues oversight of railway rates.

169. Rail deregulation, however, did not require a railroad to provide shippers access to unbundled bottleneck elements of its rail network. Professors Baumol and Willig have reasoned that unbundled access to bottleneck routes at (lower) local tariffed rates would violate the railroad's regulatory contract with the regulator to provide end-to-end services rather than network elements:

> Investment has long been attracted to the railroads under the consistent understanding that only rates for end-to-end movements, and not rates for segments, would be regulated. (We are advised that the Supreme Court so stated in 1925 in *Louisville & Nashville R.R. v. Sloss-Sheffield Steel & Iron Co.*, 269 U.S. 217, 231–34 (1925), and that the ICC repeatedly reaffirmed this point—for example, in a number of merger cases in the past decade.) On that understanding, investors have committed vast sums to provide efficient *networks*, and not merely segments. That is no less a regulatory compact than those described by Dr. [Alfred E.] Kahn for the electricity and telephone industries. That compact was, of course, reinforced still further by the Staggers Rail Act of 1980, which directed the ICC to provide railroads the opportunity to attain revenue adequacy; and it was not changed by the ICC Termination Act of 1995.[176]

Professors Baumol and Willig are thus concerned, consistent with the logic of *Northern Pacific Railway*, that a railroad would suffer stranded costs if forced to unbundle its network and to price its unbundled bottleneck routes at levels that would prevent it from recovering all of its economic costs.

170. *Northern Pacific Railway* also established that the proposed redefinition is not made any more constitutionally permissible by the fact that the state intends the redefinition to serve an important public policy goal that materially benefits the state's residents. The Court considered it beside the point that North Dakota believed that the rates would "aid in the development of a local industry," an industry whose "infancy" and potential "to confer a benefit upon the people of the State" were matters of sincere

174. Pub. L. No. 96-448, 94 Stat. 1895 (codified in scattered sections of 49 U.S.C.).

175. Pub. L. No. 104-88, 109 Stat. 803 (codified at 49 U.S.C. § 201).

176. Response of William J. Baumol and Robert D. Willig to the Verified Statement of Alfred E. Kahn 8 (Dec. 13, 1996), Central Power & Light Co. v. Southern Pac. Trans. Co., Nos. 41242, 41295, 41626, 1996 STB LEXIS 358 (Surface Trans. Bd Dec. 27, 1996) (emphasis in original) (discussing Verified Statement of Alfred E. Kahn (Nov. 27, 1996)).

concern to the state.[177] North Dakota's goal of "making the community less dependent upon fuel supplies imported into the State"[178] could not justify its resorting to an appropriation of private property as the means to achieve that objective:

> [W]hile local interests serve as a motive for enforcing reasonable rates, it would be a very different matter to say that the State may compel the carrier to maintain a rate upon a particular commodity that is less than reasonable, or—as might equally well be asserted—to carry gratuitously, in order to build up a local enterprise. That would be to go outside the carrier's undertaking, and outside the field of reasonable supervision of the conduct of its business, *and would be equivalent to an appropriation of the property to public uses upon terms to which the carrier had in no way agreed.*[179]

This passage illuminates the contemporary debate over the regulatory contract because its logic rests on the consensual nature of regulation: The firm dedicates its private property to a public purpose only as the result of voluntary exchange. Justice Hughes emphasized throughout the opinion that, although the legislature's discretion to set both general and particular rates is extremely wide and such rates enjoy a presumption of reasonableness, it is another matter entirely when the state acts to alter fundamentally the obligations imposed on the carrier by its acceptance of the original regulatory contract: "The constitutional guaranty protects the carrier from arbitrary action and from the appropriation of its property to public purposes outside the undertaking assumed . . . ."[180]

171. The Court's emphasis on the original understanding of the intended use of regulated property in *Northern Pacific Railway* sheds light on why, and the degree to which, the regulated firm would have willingly opted for asset specificity rather than asset generality in making its investments. If the regulated firm had expected that it could be required to use its dedicated property for a purpose other than that for which such property was originally dedicated, then the firm would have borne the risk that, in the newly designated purpose, the property might fail to earn a sufficient return originally understood by the utility and the municipality to be necessary to allow the firm to recover that capital and a com-

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177. 236 U.S. at 598.
178. *Id.*
179. *Id.* (emphasis added).
180. *Id.* at 604.

petitive return on such capital over its useful life. Faced with such risk, the firm presumably would have opted instead for a different kind of capital having a lesser degree of asset specificity or a shorter useful life, or both. While investment in that alternative kind of capital would have reduced the risk to the regulated firm of having its regulated property redirected to an originally unintended use, that investment might not have been the most efficient capital in terms of minimizing the cost to society of producing the service in question. If so, then the regulator's rededication of the use of the dedicated property would impose a social cost.

172. There is an additional implication, relating to entry regulation, of the requirement that the regulator not rededicate the use to which regulated property is to be put. Some states have long forbidden municipalities to grant exclusive franchises for the provision of services such as local telephony.[181] Given that the absence of franchise exclusivity raised the risk that a utility would not receive a reasonable opportunity to recover its irreversible and nonsalvageable investment in network infrastructure, and given that the utility's rates were regulated not to exceed just and reasonable levels, why would the utility's investors nonetheless have been willing to risk their capital in this manner? Perhaps such investors received a risk premium relative to the return on capital for utilities in jurisdictions that did not forbid franchise exclusivity. But it seems at least as likely that such a premium was unnecessary because the risk was not appreciable. In other words, investors even in jurisdictions that forbade franchise exclusivity may have taken sufficient comfort in knowing that their transaction-specific investments were dedicated to a *specific purpose*—namely, the provision of retail services *directly to customers* in the municipality that granted the franchise. Since the Supreme Court's decision in the *Express Package Cases* in 1885 it had been clear under the common law of common carriage that a public utility could not be required to sell interconnection to another carrier.[182] And early cases such as *Pacific*

181. E.g., TEX. CONST. art. I, § 26.

182. 117 U.S. 1 (1885); *see* MICHAEL K. KELLOGG, JOHN THORNE & PETER W. HUBER, FEDERAL TELECOMMUNICATIONS LAW 13-14 (Little, Brown & Co. 1992).

Telephone & Telegraph Co. v. *Eshleman*, decided by the California Supreme Court in 1913, emphasized that a regulator could not mandate unbundled network access to accommodate a competitor, and that a state legislature could do so *only if* it paid just compensation to the incumbent utility.[183] Thus, when investors built the first local telephone networks under nonexclusive franchises, it would not have occurred to them, or to the municipality franchising them, that the municipality (or its successor, the state public utility commission) might subsequently rededicate such regulated property to the purpose of providing a rival firm the infrastructure with which to lure away the incumbent utility's retail customers. Indeed, the early years of local telephony witnessed a race among competing facilities-based LECs with overlapping networks to maximize subscribership in a service area.[184]

173. The one form of potential competition that the utility and the municipality did originally envision was of a completely different sort. If competition were to occur, it would take the form of another utility receiving another nonexclusive franchise to build its own transaction-specific infrastructure. Yet, such facilities-based entry was not expected to occur because local exchange carriers were thought to be natural monopolies; indeed, such entry was considered futile and wasteful. That is why entry regulation, taking the form of the prior grant of certificates of necessity and convenience, placed so much emphasis on avoidance of duplicative facilities. In other words, neither the municipality nor the original franchised utility ever expected that competitive entry would take the form of mandated access to the incumbent's network.

174. Furthermore, if the incumbent's network was to be occupied—in any degree—by some party other than the utility that owned it, that party was understood to be the municipality itself. Some franchise agreements gave the municipality the option to buy out the utility's network at the end of the franchise term for a price voluntarily negotiated by the parties or, in the case of deadlock, for a price set

183. 166 Cal. 640, 664-65, 137 P. 1119, 1127-28 (1913).

184. *See* MILTON L. MUELLER, JR., UNIVERSAL SERVICE: COMPETITION, INTERCONNECTION, AND MONOPOLY IN THE MAKING OF THE AMERICAN TELEPHONE SYSTEM (MIT Press & AEI Press 1996).

by arbitration. Of course, at any time during the franchise term the municipality independently had the option simply to exercise eminent domain over the utility's network, which would trigger an analogous valuation process for determining just compensation for the forced buyout.

175. *Northern Pacific Railway* has relevance to current policies on network unbundling such as the FCC's *First Report and Order*. To price mandatory access to the incumbent LEC's network elements, the FCC introduced the concept of total ***element*** long run incremental cost (TELRIC), which is to be distinguished from total *service* long run incremental cost (TSLRIC). TELRIC embodies more than a new kind of costing exercise. It reflects a fundamental redefinition of the output of the regulated local exchange carrier. In the past, the output of a LEC consisted of services. After the FCC's 1996 interconnection order, the incumbent LEC's output has been redefined to consist of elements. The difference is significant in at least two respects.

176. First, the incumbent LEC built its network in the manner that it did so that it could discharge an obligation to serve—that is, to provide services to consumers. The incumbent LEC, however, now faces both an ongoing obligation to provide services to consumers and a new obligation to supply elements to competitors. The latter was never contemplated when the incumbent LEC dedicated the private property of its investors to a public purpose.

177. Second, there will likely be significant transactions costs of using the incumbent LEC's network to provide elements rather than services as its intended output. Those new costs are a cost of achieving the benefits that Congress and the FCC envisioned from the mandatory unbundling of local telephony. But it is neither efficient nor constitutional to make the shareholders of incumbent LECs absorb those costs. Rather, such costs must be fully recovered in the rates that an incumbent LEC may charge for unbundled elements. If demand conditions preclude setting prices for UNEs at a sufficiently high level to recover those costs, then an end-user charge must be employed to recover the residual amount of cost beyond what can be recouped through the market-allowed price.

D. It Is Not a Sufficient Response to the Takings Issues Posed by This Proceeding to Say That the Commission Can Address the Problem of Underrecovery of Costs on a Case-by-case Basis Through a Waiver Process

178. The U.S. Constitution, not the Communications Act or the Commission's rules, forbids the uncompensated confiscation of private property for a public purpose. Nonetheless, AT&T argues that, "to the extent the Commission remains concerned about the possibility of future ILEC underrecovery claims, the Commission could easily address that concern with a waiver process that would permit an ILEC to demonstrate, once the commercial consequences of the new competitive regime become apparent, that it was not in fact permitted the opportunity to recover its prudently incurred investment expenses from all revenue sources."[185] Apart from the fact that "all revenue sources" are *not* relevant to the question of recovery of the incumbent LEC's costs, it should be clear that the Commission cannot demote the constitutional protection of property to the status of an administrative hearing for the grant of a waiver from agency rules. If an incumbent LEC has been denied the reasonable opportunity to recover its full economic costs of providing regulated services, its complaint will be filed against the Commission (and states, as the case may be) in federal court. It is therefore mystifying why AT&T would identify, as an example worth emulating here, the waiver process specified in paragraph 739 of the *First Report and Order*, an agency order immediately challenged by incumbent LECs on takings grounds and stayed by the U.S. Court of Appeals for the Eighth Circuit pending that court's decision on the merits.[186]

CONCLUSION

179. The opposition of AT&T, MCI, and other interexchange carriers to market-based pricing of interstate access is not founded on sound economic reasoning. Rather, it represents an attempt to free-ride on the local exchange networks without paying the full costs. By arguing for TELRIC pricing, these companies seek to avoid paying a reasonable share of the joint and common costs of the incumbent LEC's

185. Comments of AT&T Corp. at 41.
186. *Id.* at 42 & n.68.

network. Like the government's provision of public goods, the incumbent LEC's provision of a local telecommunications network entails common costs that cannot be attributed to individual services or customers and recouped through usage-sensitive prices. If access were to be priced too low, such pricing would send incorrect signals to IXCs and other competitive entrants and would dissuade facilities-based competition, which the Telecommunications Act of 1996 seeks to promote. Conversely, if access were to be priced to high, it would invite uneconomic bypass by facilities-based competition and UNE-based competition. The Commission must strike a balance, a difficult if not impossible administrative task. Fortunately, the solution need not be carried out administratively, contrary to the assertions of opposing commenters. Instead, the Commission should allow the LECs to adjust access prices flexibly in response to market forces. Regulation should sunset as competition continues to grow.

180. Efficient access prices will not necessarily recover the costs incurred by the LECs to discharge their existing and ongoing regulatory obligations. To avoid effecting a taking, the Commission should supplement access prices with competitively neutral and nonbypassable charges on users of interstate access. The Commission should reject proposals to avoid cost recovery. Moreover, the Commission should reject the proposals of AT&T, MCI, and others for pricing *below* efficient levels by "reinitializing" price caps and imposing TELRIC pricing. Such an approach would be neither efficient nor compensatory.

* * *

I hereby swear, under penalty of perjury, that the foregoing is true and correct, to the best of my knowledge and belief.

J. Gregory Sidak

J. Gregory Sidak

Subscribed and sworn to before me this 13 day of February, 1997.

Margaret H Rattan

Notary Public

My Commission expires: ______________________.

* * *

I hereby swear, under penalty of perjury, that the foregoing is true and correct, to the best of my knowledge and belief.

Daniel F. Spulber

Daniel F. Spulber

Subscribed and sworn to before me this 12th day of February, 1997.

Notary Public

OFFICIAL SEAL
DOUGLAS C KAMBICH
NOTARY PUBLIC STATE OF ILLINOIS
MY COMMISSION EXP. 09/24/00

My Commission expires: 9/24/00.

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USTA Comments
CCB/CPD 98-12
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THE NEED FOR CARRIER ACCESS PRICING FLEXIBILITY IN LIGHT OF RECENT MARKETPLACE DEVELOPMENTS

A Primer

by

Richard Schmalensee and William Taylor

QUALIFICATIONS

Richard Schmalensee is the Gordon Y. Billard Professor of Economics at the Massachusetts Institute of Technology (MIT), Deputy Dean of the MIT Sloan School of Management, and Director of MIT's Center for Energy and Environmental Policy Research. He also is a Special Consultant to National Economic Research Associates, Inc., a Director of the Long Island Lighting Company, a former Member of the EPA's Environmental Economics Advisory Committee, and a Member of the EPA's Clean Air Act Compliance Analysis Council. He served as a Member of President Bush's Council of Economic Advisors with primary responsibility for domestic and regulatory policy, including environmental and telecommunications policy and for U.S. assistance to Central and Eastern Europe. He served for several years as a consultant to the Bureau of Economics of the Federal Trade Commission.

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He received his S.B. and Ph.D. degrees in economics from MIT and taught for some years at the University of California, San Diego. At MIT, he teaches graduate courses in industrial organization, its applications to management decisions, government regulation and government/business relations. He has published over 60 articles in professional journals, including *The American Economic Review*, *The RAND Journal of Economics*, *The Harvard Law Review*, *The Journal of Econometrics*, *Public Utilities Fortnightly*, *Econometrica*, *The Journal of Law and Economics*, *The Journal of Industrial Economics*, *The Economic Journal*, *The Antitrust Law Journal*, *The International Journal of Industrial Organization*, *The Quarterly Journal of Economics*, and *The Journal of Economic Perspectives*.

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His articles have appeared in numerous telecommunications industry publications as well as *Econometrica, the American Economic Review, the International Economic Review, the Journal of Econometrics, Econometric Reviews, the Antitrust Law Journal, The Review of Industrial Organization*, and *The Encyclopedia of Statistical Sciences*. He has served as a referee for these journals (and others) and the National Science Foundation and has served as an Associate Editor of the *Journal of Econometrics*.

QUALIFICATIONS

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